



# IMPACT OF THE TAX CUTS AND JOBS ACT ON REGULATED UTILITIES

National Conference of  
Regulatory Attorneys  
April 24, 2018  
Chicago, Illinois

Scott A. Struck, CPA  
Assistant Director  
Financial Analysis Division  
Illinois Commerce Commission  
[scott.struck@illinois.gov](mailto:scott.struck@illinois.gov)

# AGENDA

- How does the new tax law affect regulated utilities?
- What concerns to regulators need to address?
- How has the Illinois Commerce Commission addressed these concerns?

# HOW DOES THE NEW TAX LAW AFFECT REGULATED UTILITIES”

- Lower federal income tax rate for utilities with a taxable income of \$50,000 or more
- Excess accumulated deferred income taxes
- Loss of bonus depreciation
- Contributions in aid of construction once again taxable for water and sewer utilities
- Loss of NOL carryback
- Reduced cash flow because of reduced tax deferrals

# NEW TAX RATE

- Change from graduated tax rates to one tax rate of 21%

irs.gov

<i>Over—</i>	<i>But not over—</i>	<i>Tax is:</i>	<i>Of the amount over—</i>
\$0	\$50,000	<b>15%</b>	\$0
50,000	75,000	<b>\$ 7,500 + 25%</b>	50,000
75,000	100,000	<b>13,750 + 34%</b>	75,000
100,000	335,000	<b>22,250 + 39%</b>	100,000
335,000	10,000,000	<b>113,900 + 34%</b>	335,000
10,000,000	15,000,000	<b>3,400,000 + 35%</b>	10,000,000
15,000,000	18,333,333	<b>5,150,000 + 38%</b>	15,000,000
18,333,333	.....	<b>35%</b>	0

# EXCESS ACCUMULATED DEFERRED INCOME TAXES

- What are deferred income taxes?
- What are accumulated deferred income taxes?
- What are excess accumulated deferred income taxes?

# DEFERRED INCOME TAXES

- Because of differences between tax law and ratemaking, there are times when a utility will reflect an item as a deduction on its tax return in one year and reflect the benefit of that tax deduction in a later year for ratemaking.
- This creates a timing difference (deferral) between when the utility receives the tax benefit and when the utility's customers receive the tax benefit.
- The tax savings from the tax deduction are a source of cash that the utility can use until it passes those tax savings to customers in a future period
- Accumulated deferred income taxes (ADIT) track the cumulative net value of all these differences

# ACCUMULATED DEFERRED INCOME TAXES, BY EXAMPLE

Accumulated Deferred Income Taxes (ADIT) Example

\$1,000 Asset and a 35% Income Tax Rate

Tax Depreciation - 5 Years Accelerated

Ratemaking/Financial Reporting Depreciation - 10 Years Straight-Line

Line	Year	Income Tax		Ratemaking/Fin. Reporting		Deferred Income Taxes	
		Depreciation Expense	Tax Deduction	Depreciation Expense	Tax Expense	Annual (c)-(e)	Accumulated From (f)
			(b)*35%		(d)*35%		
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
1	2015	\$ 150.00	\$ (52.50)	\$ 100.00	\$ (35.00)	\$ (17.50)	\$ (17.50)
2	2016	220.00	(77.00)	100.00	(35.00)	(42.00)	(59.5)
3	2017	210.00	(73.50)	100.00	(35.00)	(38.50)	(98.0)
4	2018	210.00	(73.50)	100.00	(35.00)	(38.50)	(136.5)
5	2019	210.00	(73.50)	100.00	(35.00)	(38.50)	(175.0)
6	2020			100.00	(35.00)	35.00	(140.0)
7	2021			100.00	(35.00)	35.00	(105.0)
8	2022			100.00	(35.00)	35.00	(70.0)
9	2023			100.00	(35.00)	35.00	(35.0)
10	2024			100.00	(35.00)	35.00	0.00
11	Total	\$ 1,000.00	\$ (350.00)	\$ 1,000.00	\$ (350.00)	\$ -	

# SIGNIFICANCE OF ACCUMULATED DEFERRED INCOME TAXES

- The table we just looked at demonstrates how, when an asset is depreciated more quickly for tax purposes than it is for ratemaking purposes, there is a delay in passing the tax savings on to customers.
- This example is for a single asset. In reality, utilities are continually adding new assets and the total balance of ADIT grows with that underlying asset base.
- While most ADIT arise from temporary differences in depreciation accounting, ADIT arise for other reasons as well. These include differences in the treatment of benefit plans, bad debts, repairs, and derivatives.
- To put this in perspective, in a recent rate case, the utility's rate base would have been \$14.0 billion without the reduction for ADIT of \$4.3 billion, which reduced the utility's approved rate base to \$9.7 billion.



# EXCESS ACCUMULATED DEFERRED INCOME TAXES

- When tax rates are lowered, a utility will have accumulated more deferred income taxes than it needed to (excess ADIT).
- This happens because the utility will have accumulated the deferred income tax benefits at the higher rate prior to the tax rate change but would pass back those same benefits to its customers at the lower rate after the tax rate change.
- Since the income tax rate has dropped from 35% to 21%, this will create significant excess deferred income taxes.

# TREATMENT OF EXCESS ACCUMULATED DEFERRED INCOME TAXES

- Most entities will simply write off the liability for excess ADIT and show that as income for the current period. (ASC 740)
- Rate-regulated utilities are not permitted to do that.
  - Instead of writing off the excess ADIT, a rate-regulated utility will transfer them to a regulatory liability.
  - It is generally recognized that excess ADIT represent amounts that have been recovered in rates and should be returned to the utility's customers.
  - Tax law severely penalizes rate-regulated utilities if they return to customers the excess ADIT that result from the use of accelerated depreciation more quickly than ratably over the life of the underlying assets.
    - For this reason, excess ADIT that result from the use of accelerated depreciation are known as "protected" excess ADIT.
    - Excess ADIT that arise for reasons other than the use of accelerated depreciation are known as "unprotected" ADIT.
- Regulators have more flexibility in passing unprotected excess ADIT back to utility customers than they do with protected excess ADIT.

# OTHER IMPACTS OF THE NEW TAX LAW

- **Loss of bonus depreciation**
  - Under prior law, entities could take first year depreciation of 50% on new assets. This was to be phased out by January 1, 2020. The new law permits 100% depreciation in the first year for assets placed in service after September 27, 2017. This new provision will be phased out by 20% per year after 2022. This new provision does not apply to regulated utilities.
- **Contributions in Aid of Construction (CIAC) are once again taxable for water and sewer utilities**
  - Contributions in Aid of Construction includes money, services, or property provided to a utility at no cost which is used to offset the costs to acquire, improve, or construct property, facilities, or equipment used to provide utility services.
  - From June 13, 1996 to December 31, 2017, CIAC to water utilities were not taxable. Beginning January 1, 2018 CIAC are once again taxable. This change will likely cause water utilities to require a gross-up payment from the contributor in order for the utility to cover the additional taxes they will have to pay because of the CIAC.

# OTHER IMPACTS OF THE NEW TAX LAW

## (CONTINUED)

- **Loss of net operating loss (NOL) carry back**
  - Previously, NOLs generated in one tax year would be used to offset taxable income from other years. The NOL would first be carried back 2 years and then any remaining NOL would be carried forward up to 20 years.
  - The new tax law limits the use of NOLs generated in tax years beginning after December 31, 2017. An NOL may be carried forward to offset 80% of the taxable income in future years, but there is no longer a carry back.
  - Some utilities, engaged in significant infrastructure investment, using bonus depreciation have generated tax NOLs.
- **Reduced cash flow because of reduced tax deferrals**
  - Tax deferrals represent tax savings a utility has received but not yet passed to utility customers.
  - This means that tax deferrals are a source of cash.
  - Because the new tax law reduces tax deferrals, it also reduces cash flow for utilities.

# WHAT CONCERNS SHOULD REGULATORS ADDRESS?

- Should regulators lower utility rates to reflect the impact of the lower income tax rate?
  - Is the utility over earning now that it is incurring lower income tax expense?
  - Is it politically necessary for the regulators to “do something”?
- IRS Normalization requirements for passing “protected” excess ADIT back to utility customers
  - The new tax law requires the use of the average rate assumption method (ARAM)
  - Under ARAM, the excess ADIT is amortized over the remaining regulatory lives of the underlying assets.
  - If sufficient information is not available to implement ARAM, then the Reverse South Georgia (RSGM) method may be used. The RSGM uses an overall average or composite depreciation rate rather depreciation rates by asset class and vintage.
- Treatment of “unprotected” excess ADIT

# HOW HAS THE ILLINOIS COMMERCE COMMISSION ADDRESSED THESE CONCERNS?

- The Illinois Commerce Commission (ICC) initiated an investigation of the new tax law's impact on the rates of each Illinois public utility.
  - (Excluded 2 electric utilities who have a formula rate that changes and trues-up annually)
- Each utility was given 30 days to:
  - File new rates reflecting the new tax rate along with sufficient work papers to show the derivation and propriety of the reduced rates, or
  - Show cause why the Commission should not lower rates to reflect the reduced tax burden.
- Each utility was also directed to begin accruing a regulatory liability for the impact of the tax change. This regulatory liability would be used to fund any refunds ultimately granted.

# RESPONSES TO ICC'S SHOW CAUSE ORDER

- One utility filed lower rates.
- Others made filings to show why their rates should not be lowered.
  - Some utilities noted that they had open, ongoing rate cases in which the tax rate change was being addressed.
  - Some utilities noted that they had filed a proposed rider to account for tax changes that occur between rate cases and adjust their rates accordingly.
- For some of the smaller water and sewer utilities, ICC staff performed analyses and determined that no change was needed because either:
  - The utility is a pass-through entity and has no income taxes reflect in its rates,
  - The utility is already at a lower tax rate because of its small size, or
  - The utility is earning less than its authorized rate of return, even with the tax change.
- One small utility noted that it is being acquired by a larger utility and any rate adjustments would be addressed in that case.

# ICC'S INCOME TAX CASES

The case files for ICC cases are available on the ICC's website at the following link: <https://www.icc.illinois.gov/docket/Search.aspx>. Enter the case number into the search box to find a specific case. The case numbers for the income tax cases are the following:

Case Number	Utility Company	Case Number	Utility Company
18-0189	The Peoples Gas Light and Coke Company	18-0200	Bahl Water Company
18-0190	North Shore Gas Company	18-0201	Cedar Water Company
18-0191	Ameren Illinois Company (gas operations)	18-0202	Colonial Meadow Water Company
18-0192	Northern Illinois Gas Company (Nicor Gas)	18-0203	Forestview Utilities Corporation
18-0193	Illinois-American Water Company	18-0204	Powers Water Company, Inc.
18-0194	Aqua Illinois, Inc.	18-0205	Rockvale Corporation
18-0195	MidAmerican Energy Company	18-0206	Rockwell Utilities, LLC
18-0196	Mt. Carmel Public Utility Co.	18-0207	Silvis Heights Water Corporation
18-0197	Liberty Utilities	18-0208	Utility Services of Illinois
18-0198	Consumers Gas Company	18-0209	Sundale Utilities, Inc.
18-0199	Illinois Gas Company		